

## Message Text

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ACTION EUR-08

INFO OCT-01 SS-14 ISO-00 NSCE-00 SP-02 L-01 EB-04  
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O 061203Z MAR 78  
FM AMEMBASSY LISBON  
TO SECSTATE WASHDC IMMEDIATE 4940  
INFO AMEMBASSY BONN IMMEDIATE

C O N F I D E N T I A L SECTION 1 OF 2 LISBON 1624

LIMDIS

E.O. 11652: XGDS-3  
TAGS: ECON, EFIN, PO  
SUBJECT: GOP AND IMF DISCUSSIONS: ASSESSMENT AND COMMENT

REF: A) LISBON 1274 B) LISBON 1623

BEGIN SUMMARY. FINANCE MINISTER CONSTANCIO PAINTED A BLEAK PICTURE OF GOP/IMF DISCUSSIONS LAST WEEK. ALTHOUGH THE DISCUSSIONS RESULTED IN AGREEMENT TO SHIFT THE PROGRAM TIMEFRAME, THEY DID NOT RESOLVE OUTSTANDING DIFFERENCES ON INTEREST RATE, CREDIT CEILINGS, AND EXCHANGE RATE POLICIES. SIGNIFICANT DIFFERENCES EXIST FOR BOTH VALID ECONOMIC REASONS AND POLITICAL CONSIDERATIONS. EMBASSY BELIEVES, HOWEVER, THAT GOP, AND PRESUMABLY IMF, ARE WILLING TO CONTINUE TO SEEK A COMPROMISE AGREEMENT. IT IS ESSENTIAL THAT THE TWO PARTIES PURSUE THEIR DISCUSSIONS AND ACHIEVE AN ACCORD THAT IS BOTH ECONOMICALLY AND POLITICALLY ACCEPTABLE. END SUMMARY.

1. FOLLOWING IS EMBASSY'S ASSESSMENT AND COMMENT ON MARCH 3 CONVERSATION BETWEEN FINANCE MINISTER CONSTANCIO AND ECONOMIC COUNSELOR (REF B).

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2. CONSTANCIO CERTAINLY GAVE THE ECON COUNSELOR, AND APPARENTLY THE GERMAN AMBASSADOR, A BLEAK PICTURE OF RECENT GOP/IMF DISCUSSIONS. HIS PESSIMISM STEMS PARTLY FROM FEAR THAT IMF DEPARTED PORTUGAL WITH AN EXTREMELY NEGATIVE IMPRESSION OF GOP ECONOMIC POLICIES, PERHAPS EVEN SUFFICIENTLY NEGATIVE TO REFUSE, OR TO DELAY INDEFINITELY, A RESUMPTION OF NEGOTIATIONS. THE RECENT MEETINGS HAD

MIXED RESULTS FROM THE GOP'S POINT OF VIEW. CONSTANCIO ACHIEVED HIS PRINCIPAL OBJECTIVE OF SHIFTING THE TIMEFRAME OF THE PROPOSED ACCORD FROM CY 78 TO APRIL 78 - MARCH 79. HE APPARENTLY WAS NOT PREPARED, AND HAD NOT EXPECTED FUND MISSION, TO ENTER DETAILED DISCUSSIONS LAST WEEK. THUS HE ESSENTIALLY RESTATED THE POSITION GOP HAD TAKEN LAST NOVEMBER, WITH NOTABLE EXCEPTION OF EXCHANGE POLICY BECAUSE OF HIS HEIGHTENED SENSITIVITY TO INFLATIONARY PRESSURES.

3. CONSTANCIO AT PRESENT SEEMS TO HAVE TWO MAJOR SHORT-TERM OBJECTIVES: FIRST, TO CONVINCE FUND TO REINITIATE FORMAL NEGOTIATIONS AS SOON AS GOP HAS DEFINED ITS POSITION, I.E., ABOUT MARCH 13 OR 15; SECOND, TO CONVINCE THE FUND TO REACH A COMPROMISE SOLUTION. EMBASSY CONTINUES TO BELIEVE THAT GOP WANTS AN AGREEMENT AND WANTS IT QUICKLY. CONSTANCIO EVIDENTLY BELIEVES, HOWEVER, THAT GOP IS IN A HIGHLY DISADVANTAGEOUS NEGOTIATING POSITION BECAUSE IT IS UNDER FAR GREATER PRESSURE THAN IS THE FUND TO REACH AN ACCORD. HE EVIDENTLY FEELS THAT FUND WILL BE UNDER MORE PRESSURE AND BE MORE DISPOSED TO COMPROMISE WHEN IT IS IN A FORMAL NEGOTIATING SESSION, ESPECIALLY IF MAJOR PARTICIPANTS IN THE COORDINATED LOAN PROGRAM HAVE EXPRESSED THEIR DESIRE FOR A GOP/IMF AGREEMENT.

4. EMBASSY SUSPECTS THAT GOP, DESPITE ITS DESIRE FOR AN CONFIDENTIAL

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AGREEMENT, ADOPTED A FIRM POSITION LAST WEEK FOR THREE REASONS: FIRST, CONSTANCIO HAS NOT COMPLETED FORMULATING HIS POLICY STRATEGY AND THUS WAS NOT PREPARED TO COMMIT THE GOP TO DETAILED AGREEMENTS. SECOND, THE GOP WISHES TO ESTABLISH AN IMAGE OF INDEPENDENCE VIS-A-VIS THE FUND. FOR UNDERSTANDABLE POLITICAL REASONS, IT DOES NOT WANT TO APPEAR SUBMISSIVE, NOR TOO DEPENDENT ON FUND RECOMMENDATIONS. THE PRESS THAT IS SYMPATHETIC TO THE GOVERNMENT HAS ALREADY STARTED TO CREATE SUCH AN IMAGE OF INDEPENDENCE. VARIOUS PRESS STORIES HAVE STATED, FOR EXAMPLE, THAT LAST WEEK'S "NEGOTIATIONS" RESULTED IN NO AGREEMENT BECAUSE OF THE GOP'S RESISTANCE TO UNREASONABLE FUND DEMANDS. ONE HIGHLY RESPECTED OPPOSITION NEWSPAPER EVEN REPORTED THAT AN "EXCEPTIONALLY KNOWLEDGEABLE SOURCE" HAD TOLD IT THAT THE FUND MISSION HAD PRESSED FOR A 30 PERCENT DEVALUATION. THESE REPORTS SET THE STAGE FOR THE GOP TO "SHOW" LATER HOW IT HAS OBLIGED THE FUND TO ACCEPT "MORE REASONABLE" CONDITIONS. A THIRD GOP OBJECTIVE IS QUITE EASY TO UNDERSTAND. THE PORTUGUESE UNDOUBTEDLY WISH TO GAIN THE BEST POSSIBLE TERMS AND MAXIMUM POLICY FLEXIBILITY IN ORDER TO DEAL WITH UNANTICIPATED DEVELOPMENTS. THIS DESIRE MAY, HOWEVER, LEAD THEM TO UNDERESTIMATE THE NEEDED SEVERITY

OF REFORM MEASURES.

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5. EMBASSY CONCURS THAT USG AND OTHER MAJOR CREDITORS DO HAVE A ROLE IN GOP/IMF NEGOTIATIONS. THE FUND APPARENTLY IS SEEKING, UNDERSTANDABLY, TO AVOID SOME OF THE CRITICISM DIRECTED AT IT FOR BEING "TOO HARSH" ON PORTUGAL. IT MUST, HOWEVER, CONTINUE ITS NEGOTIATIONS AND PRESS FOR AN ACCEPTABLE AGREEMENT. IN OUR VIEW, IT IS ESSENTIAL THAT THE COMPROMISE REQUIRED FOR AN AGREEMENT NOT UNDERMINE THE EFFECTIVENESS OF THE STABILIZATION PACKAGE.

A. CREDIT POLICY: CONSTANCIO HAS CLEARLY SIGNALLED HIS WILLINGNESS TO COMPROMISE ON THE CREDIT CEILING. EMBASSY STRONGLY SUSPECTS THAT HE CAN BE PRESSED TO ACCEPT A CEILING THAT IS MUCH CLOSER TO THE IMF POSITION.

B. INTEREST RATES: THE SPREAD BETWEEN THE IMF REQUESTED SEVEN POINT RISE AND THE GOP OFFER OF A THREE POINT RISE CREATES A HIGHLY CONTENTIOUS ISSUE. WE WOULD HOPE THAT THIS DIFFERENCE COULD BE BRIDGED BY INITIATING A TWO STAGE INCREASE, WITH THE FIRST STEP CLOSER TO THE PORTUGUESE PROPOSAL.

C. EXCHANGE POLICY: EMBASSY BELIEVES CONSTANCIO'S PROPOSED INITIAL FIVE PERCENT DEVALUATION AND A SUBSEQUENT RAPID CRAWL ARE UNACCEPTABLE. CRAWLING AT

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THE RATE HE SUGGESTS, ESPECIALLY GIVEN LOW INTEREST RATES, WOULD ENCOURAGE CAPITAL FLIGHT, EXCESS STOCKING, ACCELERATED REMITTANCE OF DIVIDENDS AND SERVICE PAYMENTS, ETC. THE CRAWL, AFTER THE INITIAL DEVALUATION, MUST BE SLOW IN ORDER TO ESTABLISH GREATER CONFIDENCE IN THE ESCUDO. IF SUCH CONFIDENCE IS NOT ESTABLISHED BY EARLY MAY, PORTUGAL WILL NOT MAXIMIZE ITS EMIGRANT RECEIPTS AND TOURISM EARNINGS. CONVERSELY, THE INITIAL DEVALUATION MUST BE RATHER LARGE, I.E., AT LEAST TEN PERCENT. THE IMF PREFERENCE FOR A SUBSTANTIAL, OFFICIAL DISCRETE MOVEMENT, HOWEVER, WOULD BE VERY DIFFICULT POLITICALLY. THE PUBLIC, HIGHLY SENSITIVE TO LARGE DISCRETE EXCHANGE MOVEMENTS, HAS THUS FAR REACTED MILDLY TO THE ESCUDO'S DOWNWARD CRAWL. THUS A RAPID INITIAL CRAWL, RATHER THAN A DISCRETE MOVEMENT, MAY BE FAR MORE ADVISABLE POLITICALLY. IF DONE WITHIN A VERY SHORT TIME FRAME, E.G., TWO WEEKS, FOLLOWED BY A SLOW CRAWL AND A FIRM STATEMENT ON FUTURE EXCHANGE POLICY, THIS PROCEDURE COULD BE ECONOMICALLY EFFECTIVE AS WELL.

6. THE FOREGOING IS ONLY ONE POSSIBLE COMPROMISE SCENARIO. EMBASSY MAINTAINS THAT IMF AND GOP, BY ADOPTING A DETERMINED POSITIVE ATTITUDE, SHOULD BE ABLE TO FIND OTHERS, ONE OF WHICH WOULD BE BOTH POLITICALLY AND ECONOMICALLY FEASIBLE.

7. WE WILL CONTINUE TO IMPRESS UPON CONSTANCIO AND OTHER GOP LEADERS NEED TO FACE ECONOMIC REALITIES AND REACH PROMPT, VIABLE ACCORD WITH IMF.  
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